# Eliminating the Double Tax on Corporate Income

Council of Economic Advisers
January 7, 2003

## Proposal

- Permit shareholders to exclude 100 percent of dividends from tax.
- The exclusion applies only to dividends from corporate income subject to the corporate income tax.
- Extend relief of double taxation to retained earnings.

## Eliminating the Double Taxation of Dividends

The President's proposal aims to improve economic growth and flexibility by eliminating the tax bias against equity-financed investments, thereby promoting saving and investment. Excluding dividends from the individual income tax eliminates the double tax on corporate income and moves our tax system closer to one that taxes all income once, but only once. This reduces the tax bias against capital income in the current tax system, encourages investment, and enhances the long-term growth potential of the U.S. economy. Higher investment promotes job creation and higher wage growth.

Eliminating the double tax on corporate income can be accomplished in a number of different ways. Perhaps the simplest with the smallest number of changes to the current tax system is to permit shareholders to exclude their dividend income from tax. A dividend exclusion, combined with eliminating the double taxation of retained earnings, provides an important step toward reducing tax-based distortions of economic decisions. Such distortions, discussed in detail below, include dividend payout policy, debt versus equity financing, organizational form, and current versus future consumption (that is, saving).

A neutral tax policy toward dividends will also provide important benefits for corporate governance. Reducing tax barriers to dividend payments will help provide investors with improved information about corporate prospects and reduce the tax-motivated buildup of cash left to managers' discretion.

Recognition of the desirability of providing relief from the double tax on corporate income is not new. The impetus behind past proposals to integrate the individual and corporate taxes, including the January 1992 Report of the U.S. Treasury Department, *Integration of the Individual and Corporate Tax Systems* (and the report at the same time by the American Law Institute), was to reduce economic distortions created by the double tax on corporate income.

The Treasury Department estimates that eliminating the double taxation of corporate income would lower federal revenues by about $364 billion over ten years. The Treasury study from a decade ago suggested that even in the absence of increased investment eliminating double taxation would eventually raise economic welfare in the United States by about 0.5 percent of consumption, equal to about $36 billion each year (in 2003 dollars). Put differently, the reduced distortion of business decisions would be equivalent to receiving additional income of $36 billion every year forever. In addition, higher investment due to the lower tax on capital income would promote higher wages in the long-run. The proposal would also be expected to enhance near-term economic growth.

*International Experience*

Many of our trading partners already provide some form of relief for double taxation of corporate income. As shown in Table 1, all countries in the G-7 but the United States provide at least some relief from the double tax on dividends. Italy provides full relief. Relief is provided at the shareholder level through either an imputation credit system or dividend exclusions. Germany has a 50 percent dividend exclusion, and the United Kingdom has a preferential rate on dividends plus a system in which shareholders receive partial credit for taxes paid at the corporate level. Among G-7 countries, the United States has the second highest combined (corporate and individual) effective tax rate on dividends. The effective 60 percent rate in the United States exceeds the rates in all other G-7 countries.

Table 1.-- Double Taxation Among G-7 Countries

| | Maximum Individual Rate | Maximum Corporate Rate | Maximum Effective Rate on Dividends | Dividend Exclusion | Imputation System |
|---|---|---|---|---|---|
| | | | (in percent) | | |
| Canada | 29 | 29 | 43 | | Partial |
| France | 54 | 34 | 55 | | Partial |
| Germany | 51 | 26 | 45 | 50 | |
| Italy | 45 | 36 | 45 | | Full |
| Japan | 37 | 30 | 52 | Capped 1/ | Partial |
| United Kingdom | 40 | 30 | 48 | Preferential Rate 2/ | Partial 2/ |
| United States | 38.6 | 35 | 60 | | |

Note: Effective tax rates are for profits paid out from domestic source income as dividends by domestic companies to domestic shareholders.

1/ Exclusion allowed up to Y100,000 ($US 833 at current exchange). Taxpayers excluding dividends forgo the credit for the withholding tax at source.

2/ Credits only fully offset the individual level tax on dividends for individuals in a lower tax bracket.

Source: Juhani Kesti (ed.), European Tax Handbook 2002, International Bureau of Fiscal Documentation, Amsterdam, 2002 and International Bureau of Fiscal Documentation, Taxes and Investment in Asia and the Pacific, Supplement No. 197, January 2001.

*Economic Effects*

There is general agreement among economists that dividend taxes increase the cost of capital for investment financed with new share issues. Corporate income from a newly equity-financed project is subject to two layers of tax. First, the corporate tax is paid on earnings at the firm level at a maximum rate of 35 percent. For income distributed as a dividend, the second layer of tax is paid by individual shareholders at a maximum tax rate of 38.6 percent. Alternatively, shareholders pay tax on the appreciation in stock value that arises from corporate earnings that are retained and reinvested in the firm at a maximum statutory tax rate of 20 percent.[1] The total effective tax on corporate income from investments financed with new share issues is calculated by combining the two layers of tax.

As shown in Table 2 below the effective tax on corporate income distributed to shareholders as dividends can be as high as 60.1 percent. The effective rate on corporate income (from a new-equity-financed project) that is retained by the firm and realized by a shareholder as capital gains is about 40.9 percent taking into account the preferential tax rate on capital gains realizations and the benefits of tax deferral. The effective tax rate on dividends would be 35.0 percent under the proposal, a reduction of over 40 percent. As shown below, the effective tax rate on corporate income that is retained and taxed as capital gains when realized would fall by nearly 15 percent.

Table 2. Effect of Proposal on Effective Tax Rates on Various Economic Decisions For a Hypothetical Investor at the Top Statutory Tax Rate

| | Current Law | 100% Dividend Exclusion | 100% Dividend Exclusion Plus Advancing of Rate Reduction |
|---|---|---|---|
| | | (in percent) | |
| Dividends | 60.1 | 35.0 | 35.0 |
| Retained Earnings | 40.9 | 35.0 | 35.0 |
| Debt | 38.6 | 38.6 | 35.0 |
| Pass-through income | 38.6 | 38.6 | 35.0 |

Note: All calculations are for a new-equity-financed project and assume a 35 percent corporate tax rate and the 35 percent individual tax rate on ordinary income in 2003 (as the President's proposal also advances the reduction in individual tax rates enacted under EGTRRA). Under current law, an effective 9 percent rate is assumed for capital gains realizations (that is, the 18 percent rate multiplied by 0.5 to reflect the benefits of tax deferral). Under the proposal, a basis adjustment would be provided to shareholders for corporate earnings that is retained. Calculations include only federal taxes.

[1] The statutory tax rate on long-term capital gains held for more than five years is 18 percent, but taxes are deferred until the asset is sold, thereby lowering the effective rate of tax on capital gains. The example does not incorporate taxpayers who hold assets until death, receive a step-up of basis, and further reduce the effective tax rate.

The calculations in Table 2 are for taxpayers subject to the top individual income tax rate. For taxpayers subject to the 27 percent tax rate, the effective tax rate on dividends from a project financed by new equity would fall from 52.6 percent to 35 percent. The effective tax rate on corporate earnings received by shareholders as capital gains would fall from 40.9 percent under current law to 35 percent under the proposal. For taxpayers subject to the 15 percent rate, the effective rate on dividends would fall from 44.8 percent to 35 percent and the effective tax rate on corporate income received by investors as capital gains would fall from 37.6 percent to 35 percent.

The effect of the tax on dividends on investments financed with retained earnings is less clear. Some evidence suggests that dividend taxes have little or no effect on marginal investment decisions for projects financed with retained earnings. Instead, taxes on dividends from investments financed with retained earnings are reflected in share values. While it is difficult to say exactly to what extent dividend taxes are reflected in share prices, research generally finds evidence consistent with the view that at least a portion of the shareholder level taxes on dividends are capitalized into share prices. That is, elimination of the dividend tax increases the after-tax value of dividends and, thus, the price investors are willing to pay for corporate equities. If the repeal of the double tax is completely reflected in share prices, the effective rate on corporate investment would fall by perhaps 7.5 percent.

If instead, the tax burden imposed on corporate income paid out as dividends distorts marginal investment decisions, the proposal will reduce the role taxes play in several important business decisions. The major benefits of reducing the tax burden are the resulting decline in tax distortions of corporate debt-equity decisions, dividend payout policy, and the choice of organizational form, as well as the overall reduction in the tax on capital income. The proposal could greatly reduce the tax burden on corporate investment, with the effective tax rate falling by as much as one-third, from 32.2 percent under current law to 21.7 percent under the proposal. A dividend exclusion would reduce the tax penalty on corporate investment relative to noncorporate investment and the relative advantage of owner-occupied housing over business fixed investment. The dividend exclusion would thus promote tax neutrality. By lowering the tax cost of corporate investment, a dividend exclusion could also lower the economy-wide average effective tax rate on capital income by as much as one-quarter (from 19.8 percent to 14.8 percent) and improve the overall incentive to save and invest.

<u>Enhancing Economic Growth</u>. The double tax on corporate income is ultimately reflected through a lower after-tax return all capital. The proposal would reduce this distortion and thus increase capital accumulation and lead to higher wages. The ultimate effect of the proposal on capital accumulation depends on a number of factors including international capital flows. The lower economy-wide cost of capital increases investment, but some of the incremental savings would flow abroad, dampening the increase in the domestic capital stock. The results from an open economy model that incorporates international capital flows presented in the 1992 Treasury Integration Report suggests that the domestic capital stock would increase by 0.9 percent.

<u>Removing the Tax Bias Against Dividends</u>. Corporate income currently paid out as dividends is tax-disadvantaged relative to corporate income that is retained. Ultimately what determines a

firm's value is its investment policy. In the absence of taxes, in some respects, the payout policy of the firm should not matter since firms' best enhance value by making investments with the highest returns. But the double tax on corporate income may distort the dividend payout policy. In addition, the tax on dividends discourages investment by newer firms that tend not to have internal funds and rely instead on the equity capital markets for financing. Conversely, the heavier tax burden on dividends encourages investment in established firms with internally-generated earnings and investment, because these firms will tend to have more retained earnings as a result of the tax distortion. The double tax on corporate income also distorts distributions in favor of share repurchases rather than dividends.

The dividend yield has fallen from about 4.2 percent in the 1980s to 1.2 percent in March 2000 near the height of the stock market (and to 1.8 percent in December 2002). Share repurchases have grown dramatically in the past two decades representing less than 10 percent of earnings in the early 1980s, and nearly 50 percent of earnings in the late 1990s. The fraction of corporate income paid out as dividends may rise by as much as 4 percentage points (based on the 1992 Treasury study).

<u>Improving Corporate Governance</u>. Dividends may also affect firm value through avenues other than the investment policy of a firm. In particular, they may provide a number of important benefits to investors that have a direct bearing on corporate governance. Payment of dividends may provide a signal to investors of a company's underlying financial health and profitability. Dividends may be a particularly potent signal in the backdrop of the shaken confidence in corporate financial statements – a firm cannot pay dividends for any length of time unless the company has the earnings to support such payments. Corporate managers and company directors may have better information about the firm's future cash flows than those outside the company, and dividend payments may provide a channel through which firms can provide investors signals that reflect this information.

Dividend payments may also be one way for shareholders to impose discipline on corporate managers by limiting the funds over which managers' have discretion. Reducing the cash at the discretion of management may force management to undertake only the most productive investments rather than purchases that do not necessarily increase shareholder value.

<u>Reducing the Tax Bias Against Equity</u>. New equity financing is tax disadvantaged relative to debt financing because interest income is generally subject to only one layer of tax at the individual tax rate. Table 2 shows the effective tax rate on interest earnings at 38.6 percent under current law, the maximum tax rate on ordinary income. Higher debt burdens leave firms particularly vulnerable during a downturn in the economy or periods of weak economic performance. Encouraging debt finance through the tax system results in the increased risk of bankruptcy and financial distress. Failures result in losses to both shareholders and employees alike. The proposal reduces the capital market risks and instability associated with tax-induced high ratios of debt to equity. Under the proposal, the leverage ratio (calculated as the ratio of debt to assets) can be expected to fall by between 2 percent and 7 percent (as reported in the 1992 Treasury study).

Letting Business Strategy Determine Organizational Form. Capital flows to and from each sector in the economy until risk-adjusted after-tax returns are equalized. The high tax on corporate income distorts the allocation of capital by discouraging investment in the corporate sector in favor of owner-occupied housing and the noncorporate business sectors (S-corporations, partnerships, sole proprietors, and non-profits). This misallocation entails inefficient use of resources and reduces productivity and incomes. The use of the corporate form is discouraged by the higher tax on corporate income despite the nontax benefits of incorporation, such as limited liability and more centralized management. The corporate and noncorporate forms may also offer different advantages with respect to scale economies and developing entrepreneurial skill which are not fully exploited because of the tax distortion. According to the 1992 Treasury study, the proposal would increase the corporate share of capital in the economy by over 4 percent in the long run.

**Taxing Corporate Income Once, and Only Once**

The objective of the proposal is to ensure that corporate income is taxed once and only once. Consequently, corporate income that is not taxed at the firm level would not be eligible to be excluded from the individual income tax. While the way in which corporations calculate their tax would be largely unaffected, corporations would need to track corporate income that is *fully-taxed*, since the goal is to relieve tax on this income.

Corporations would track fully taxed corporate income by setting up excludable distribution accounts (EDAs). Additions and subtractions from these accounts would enable corporations to distinguish between corporate income that is fully-taxed or only taxed partially or not at all. Only corporate dividends paid from EDAs would be excludable from a shareholder's income when they pay their individual tax. Other corporate dividends (for example, returns to capital and income that is taxed partially or not at all at the corporate level) would be included in a shareholder's taxable income and subject to the individual level tax.

Eliminating the double taxation of dividends may lead to a tax-based imbalance between dividends and retained earnings, since investors would still pay the capital gains tax on the sale of stock that appreciates in value in response to retained earnings. However, under current law, companies may implement dividend re-investment programs that "pay" a dividend, re-invest the dividend in the firm, and provide shareholders with an appropriately higher cost basis. At present, however, the shareholder is liable for individual taxes on dividends deemed to be paid as part of a reinvestment program, providing little incentive for such programs.

Eliminating the double tax on dividends also eliminates the tax bias against dividend re-investment programs, providing a way to balance the tax treatment of dividends and retained earnings. The proposal requires that a corporation determine the amount of retained earnings and treat these as "deemed" dividends that would be deducted from the corporation's EDA. Shareholders' basis would be increased by the amount of the deemed distribution. This neutral treatment would make it solely a business decision whether a firm should pay dividends to shareholders or retain cash for corporate investment purposes.